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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 341

JOHN G. (J. G.) SCHERF, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

GEORGE H. BARNES AND ADA E. BARNES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 47–59) is reported at 7 T. C. 346. The opinion of the Circuit Court of Appeals (R. 195–199) is reported at 161 F. 2d 495.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 16, 1947. (R. 200.) Taxpayers'

petition for rehearing was denied June 17, 1947. (R. 209.) The petition for a writ of certiorari was filed September 12, 1947. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that business income attributed by taxpayers to their children under so-called partnership agreements was includible in taxpayers' respective gross incomes as defined in Section 22 (a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*.

STATEMENT

The facts found by the Tax Court (R. 47–57) may be summarized as follows:

In 1938 taxpayers[1] became equal partners in a pants manufacturing business conducted under the firm name of S & B Manufacturing Company. Scherf ran the office and attended to financial matters, while Barnes managed the manufacturing operations. The business had about 200 employees. At the close of 1939 the net book worth of the business assets was $32,321.30. (R. 48.)

[1] The term "taxpayers" whenever appearing herein has reference to petitioners John G. Scherf and George H. Barnes; Mrs. Barnes is a party only because she and her husband filed a joint return for the taxable year. (R. 47–48.)

Scherf had two sons, Paul and John, Jr.; Barnes had two daughters, Mildred and Ruth. In 1940, at the time of formation of the partnership here involved, Paul was 28, married, and employed by the Alabama Textile Products Company, a shirt and underwear manufacturing corporation of which his father was president and controlling stockholder. John, Jr., and Mildred were each 20 and attending college. Ruth was 18 and attended preparatory school. (R. 48, 49, 54.)

On May 16, 1940, taxpayers executed identical instruments of assignment transferring to each of their respective children, in consideration of love and affection, an undivided one-sixth interest in the S & B Manufacturing Company. On or about the same date taxpayers and their children executed a partnership agreement, dated as of January 1, 1940. After reciting the gifts the agreement provided that the partnership was to continue until dissolved by mutual agreement; that the business was to be conducted under the same name, at the same place, and with the same assets, as before; that the parties were to share equally in profits or losses; and that taxpayers were to be the "managing partners" and the children "investing partners," Scherf to have charge of financial matters and Barnes of manufacturing operations. Gift tax returns covering the transfers were filed. (R. 49–53.)

In assigning undivided interests in the business assets to their children, taxpayers intended, and the children understood, that the assets should remain in the business. The children contributed no capital to the business other than the interests donated to them by taxpayers. (R. 53, 58.)

After formation of the new partnership the business was conducted in the same manner as before. Scherf continued to manage the office and financial affairs, while Barnes continued to super vise manufacturing operations. Throughout 1940 (the taxable year) Paul continued in the employ of the Alabama Textile Products Company, and received a salary of $3,400 from that company for the year. He knew nothing about the operations of the S & B Manufacturing Company; up to the latter part of 1940 his activities were limited to learning about the business and keeping some personnel files, and he took no active part in the business during 1940. John, Jr. left college in September of 1940, became employed by the Alabama Textile Products Company, and received a salary from it of $312.97 in that year; he learned to operate a billing machine and did some billing for the S & B Company in 1940. Mildred and Ruth continued to attend school until 1943, but did some clerical work during their summer vacation in 1940. (R. 54–55.) None of the children contributed vital services during the taxable year, nor did any of them participate in management of the business. (R. 58–59.)

The books of the old partnership were not closed when the new partnership was formed, but were continued in use during the taxable year. A capital account for each child was set up on the old books when he or she made the first withdrawal of income. Mildred and Ruth each withdrew $200 in July 1940, $800 in September 1940, and $1,467.67 on December 14, 1940; the other parties each withdrew $2,467.67 on December 14, 1940. When the old partnership books were closed in January 1941, the capital account of each child was credited, as of January 1, 1940, with one-sixth of the net worth of the old partnership plus one-sixth of the 1940 net income of the business; the income shares so credited to the children were later adjusted to reflect a credit of only one-sixth of the 1940 net income allocable to the period subsequent to May 16, 1940, the date the new partnership was formed. (R. 56–57.)

The 1940 net income of the business was $36,213.42. In the partnership return for that year 136/365 of this amount was allocated to the old partnership (covering the period up to May 16, 1940) and 229/365 was allocated to the new partnership (covering the remainder of the year). The portion allocated to the old partnership was reported as distributable to taxpayers in equal one-half shares, and the portion allocated to the new partnership was reported as distributable to taxpayers and their children in equal one-sixth shares. In their individual tax returns for 1940

taxpayers and their children reported income from the business in accordance with such allocation. (R. 55–56.) The Commissioner determined that taxpayers were each taxable on one-half of the 1940 net business income, resulting in the deficiencies in controversy. (R. 57.) The Tax Court concluded that the children were not real partners during the taxable year (R. 57–59), and sustained the Commissioner's determination (R. 60–61). The Circuit Court of Appeals affirmed. (R. 195–199.)

ARGUMENT

There is no occasion for further review. This case is controlled by *Commissioner* v. *Tower*, 327 U. S. 280, and *Lusthaus* v. *Commissioner*, 327 U. S. 293, with which the decision below is in accord.

1. The question here is the same as in the *Tower* and *Lusthaus* cases, *supra*. This Court there held that (1) family partnerships erected upon gifts of business capital are without federal income tax significance, though valid under state law, if the arrangement produces no substantial change in the creation of the business income but merely a reallocation of the income within the donor's family; (2) whether the claimed partnership—so tested—has reality presents a question of ultimate fact for the Tax Court, whose determination is conclusive on appeal if supported by substantial evidence; and (3) unless the donee "invests capital originating with her or substantially contributes to the control and management of the

business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is justified in concluding that the donee is not a real partner for tax purposes. The Circuit Courts of Appeals have applied these principles in a variety of contexts and an impressive array of cases, both before and after *Tower* and *Lusthaus.*[2]

Properly addressing itself (R. 58) to the "basic question" of who really earned the business in-

[2] SECOND CIRCUIT: *Seifert* v. *Commissioner*, 157 F. 2d 719; *Seibert* v. *Commissioner*, 156 F. 2d 227; *Miller* v. *Commissioner*, 150 F. 2d 823; *Waldburger* v. *Helvering*, 131 F. 2d 598. THIRD CIRCUIT: *Eisenberg* v. *Commissioner*, 161 F. 2d 506; *Davis* v. *Commissioner*, 161 F. 2d 361; *Walker* v. *Commissioner*, 160 F. 2d 313; *Lusthaus* v. *Commissioner*, 149 F. 2d 232, affirmed, 327 U. S. 293; *Sweigard* v. *Commissioner*, 149 F. 2d 646. FOURTH CIRCUIT: *Wilson* v. *Commissioner*, 161 F. 2d 556; *Mauldin* v. *Commissioner*, 155 F. 2d 666; *Hash* v. *Commissioner*, 152 F. 2d 722, certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879. FIFTH CIRCUIT: *Benson* v. *Commissioner*, 161 F. 2d 821; *Belcher* v. *Commissioner*, decided July 2, 1947 (1947 C. C. H., par. 9308); *Mead* v. *Commissioner*, 131 F. 2d 323, certiorari denied, 318 U. S. 777; *Argo* v. *Commissioner*, 150 F. 2d 67, certiorari denied, 326 U. S. 762; *Sewell's Estate* v. *Commissioner*, 151 F. 2d 806, certiorari denied, 327 U. S. 805; *Sewell* v. *Commissioner*, 151 F. 2d 765, certiorari denied, 327 U. S. 783; *Dawes* v. *Allen*, 157 F. 2d 518; *Blalock* v. *Allen*, 151 F. 2d 927; *Morton* v. *Thomas*, 158 F. 2d 574, certiorari denied, 330 U. S. 834; *Singletary* v. *Commissioner*, 155 F. 2d 207; *Schroder* v. *Commissioner*, 134 F. 2d 346; *Villere* v. *Commissioner*, 133 F. 2d 905; *Covington* v. *Commissioner*, 103 F. 2d 201; *Kasch* v. *Commissioner*, 63 F. 2d 466, certiorari denied, 290 U. S. 644; cf. *Thomas* v. *Feldman*, 158 F. 2d 488. SIXTH CIRCUIT: *Dawson* v. *Commissioner*, decided September 22, 1947, not yet re-

come (*Commissioner* v. *Tower, supra,* pp. 283, 289), the Tax Court found that taxpayers' children contributed no capital other than what they contemporaneously received by way of gift from taxpayers, performed no vital services, and did not participate in management (R. 53–55, 58–59); in short, that during the taxable year "the business was continued in the same manner as before" (R. 54). The court below held that these findings were not merely supported but were demanded by the evidence (R. 199), and they are not in dispute. They amply warrant the Tax Court's conclusion (R. 58) that the donee-children were not real partners and that taxpayers earned, and hence were taxable, on the shares of business income attributed to the children. *Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra.*

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ported; *Lowry* v. *Commissioner*, 154 F. 2d 448, certiorari denied, 329 U. S. 725; *Lorenz* v. *Commissioner*, 148 F. 2d 527, certiorari denied, 327 U. S. 786; *Thorrez* v. *Commissioner*, 155 F. 2d 791; *Camfield* v. *Commissioner*, 154 F. 2d 1016; *Livie* v. *Commissioner*, 155 F. 2d 728; *Ewing* v. *Commissioner*, 157 F. 2d 679; *DeKorse* v. *Commissioner*, 158 F. 2d 801; *Greenberg* v. *Commissioner*, 158 F. 2d 800; *Schreiber* v. *Commissioner*, 160 F. 2d 108. SEVENTH CIRCUIT: *Appel* v. *Smith*, 161 F. 2d 121; *Tinkoff* v. *Commissioner*, 120 F. 2d 564; cf. *Wilson* v. *Commissioner*, 161 F. 2d 661. EIGHTH CIRCUIT: *Doll* v. *Commissioner*, 149 F. 2d 239, certiorari denied, 326 U. S. 725; *Supornick* v. *Commissioner*, 150 F. 2d 110; *Tyson* v. *Commissioner*, 146 F. 2d 50; cf. *Durwood* v. *Commissioner*, 159 F. 2d 400. TENTH CIRCUIT: *Earp* v. *Jones*, 131 F. 2d 292, certiorari denied, 318 U. S. 764; *Grant* v. *Commissioner*, 150 F. 2d 915; *Bradshaw* v. *Commissioner*, 150 F. 2d 918; *Losh* v. *Commissioner*, 145 F. 2d 456.

Here, as in the *Tower* and *Lusthaus* cases, every ingredient productive of the income in question—capital, services, and management—emanated from the taxpayers. While titular ownership of some of the business assets was shifted to the children (R. 49), and specified shares of the business profits were ascribed to them as "investing partners" (R. 52), taxpayers continued as before to create the income. The children became "partners" in name and on paper only.[3] Under familiar rules governing the scope of judicial review of Tax Court decisions, reiterated by this Court in the *Tower* and *Lusthaus* cases themselves with reference to the very question here presented, affirmance of the Tax Court's decision by the court below was clearly correct.

2. Taxpayers' assertion (Pet. 9–10) that the decision below subjects them to tax on income from property they no longer "owned", and is therefore in conflict with *Hoeper* v. *Tax Commission,* 284 U. S. 206, and *Heiner* v. *Donnan,* 285

[3] Not even the usual bare legal and accounting formalities were here fully observed. It does not appear that the old partnership between taxpayers was dissolved upon admission of their children as partners; the books of the old partnership were continued in use throughout the taxable year, and capital accounts were not set up for the children until they received an initial distribution of the profits. (R. 56.) Moreover, taxpayers did not distribute all of the income allocated to the children, but retained a substantial part of it in the business (R. 55–56); they thus continued to enjoy control over some of the income (as well as all of the corpus) of the partnership interests they purported to give away.

U. S. 312, begs the issue by assuming, contrary to the controlling decisions (*Commissioner* v. *Tower, supra; Helvering* v. *Clifford,* 309 U. S. 331; cf. *Harrison* v. *Schaffner,* 312 U. S. 579; *Helvering* v. *Horst,* 311 U. S. 112; *Commissioner* v. *Harmon,* 323 U. S. 44), that a gift of naked legal title to property suffices to insulate the donor from income tax. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided". *Commissioner* v. *Tower, supra,* p. 291. Equally unfounded is taxpayers' assertion (Pet. 10) of conflict with the *Tower* and *Lusthaus* cases; the Tax Court reached the same conclusion in this case as it did in those cases, and the evidentiary support for its conclusion is no more assailable here than it was there.

3. Taxpayers' elaborate argument (Br. 14–27) is essentially the same as that which this Court rejected in the *Tower* and *Lusthaus* cases. Inquiry into the reality of a family partnership is not, as they assume, to be confined to cases where the business income is derived exclusively from services, nor is it to be delimited by what portions of the income are attributed respectively to capital and services.[4] The situation here is no

[4] The unreality of the instant arrangement is accentuated by the fact that although taxpayers performed vital services and the children did not, apparently no compensation was deducted for taxpayers' services in computing the income shares ascribed to the children. The latter each purportedly

different from any other in which a taxpayer anticipatorily assigns his income. Whatever the legal cast of the arrangement, he does not escape the tax. It is immaterial whether the income be derived from services (*Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Eubank*, 311 U. S. 122), or from property of which he remains the substantial owner (*Harrison* v. *Schaffner, supra; Helvering* v. *Clifford, supra*), or, as here, from a blend of both sources (*Commissioner* v. *Tower, supra; Lusthaus* v. *Commissioner, supra*). Had taxpayers simply and directly assigned portions of their future business income to their children, they unquestionably would remain taxable on the assigned income. That they circuitously reached the same result by means of a formally perfect partnership arrangement obviously does not produce a different tax result. Unless the donee-partners contribute new capital, or perform vital

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contributed as "investing partners" one-sixth of the $32,321.30 of the net business assets, or about $5,387 (R. 48–49, 50–51); the income they each reported for the period May 16, 1940, to December 31, 1940, amounted to $3,786.81 (R. 55–56)—a return within 7½ months of over 70% of their so-called investment. Even on taxpayers' postulate that they are taxable only on that portion of the business income derived from their services, they could not prevail, for they offered no evidence from which an apportionment could be made. And since taxpayers had the burden of proving the Commissioner's determination, presumptively correct, to be wrong (*Commissioner* v. *Tower, supra*, p. 286, fn. 4; *Welch* v. *Helvering*, 290 U. S. 111), in the absence of such evidence the entire deficiency must be deemed correct. Cf. *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 594.

additional services, or participate in management—admittedly not the case here—there is no change in the creation of the business income and, accordingly, no change in the tax incidence. To permit the tax consequences to turn upon the considerations stressed by taxpayers would sanction the very type of formalism which this Court in the *Tower* and *Lusthaus* cases refused to recognize as effectual to alter tax liability.

CONCLUSION

The decision below is correct. This case turns upon its facts and presents no question calling for further review. There is no conflict of decisions. The petition should therefore be denied.

Respectfully submitted.

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OCTOBER 1947.

APPENDIX

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.
(26 U. S. C. 1940 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
(26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.
(26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss

of the partnership, computed as provided in section 183 (b).
(26 U. S. C. 1940 ed., Sec. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctively expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * * *

(26 U. S. C. 1940 ed., Sec. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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